REPUBLIC OF CROATIA
FISCAL POLICY COMMISSION

2021 ANNUAL REPORT OF THE FISCAL POLICY COMMISSION

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Table of contents

1. About the Fiscal Policy Commission

The work and activity of the Fiscal Policy Commission (hereinafter: Commission or FPC) took place in several stages. Initially, in 2011, by the Decision on the Establishment of the Fiscal Policy Committee (Official Gazette 40/11), the Fiscal Policy Committee was founded (hereinafter: Committee) as the professional body presided by the minister of finance.

Needing to strengthen the Committee's independence pursuant to the provisions of the Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States and to enhance the role of the Committee as the body supervising the implementation of the Fiscal Responsibility Act (hereinafter: FRA; Official Gazette 139/2010), on 18 December 2013 the Croatian Parliament adopted the Decision on the Establishment of the Fiscal Policy Commission (OG 156/13)[1]. According to this Decision, the Commission became the second working body of the Croatian Parliament responsible for monitoring the implementation of the FRA separate from the executive authority, i.e. the Ministry of Finance. The Council Directive 2011/85/EU was transposed into the new Fiscal Responsibility Act (OG 111/18), and the Commission was defined as a permanent, independent and autonomous professional body with greater authority to supervise the application of the FRA as well as the implementation of the country's fiscal policy in its entirety. Those amendments were primarily aimed at improving the public finance system, that is, promoting mid- and long-term sustainability of public finances pursuant to the FRA.

Public finances are essential for exercising public state functions defined by the Constitution, and their mid- and long-term sustainability is crucial for social and economic prosperity. The sustainability of public finances is achieved by establishing, applying and strengthening fiscal rules and the rules for ensuring fiscal responsibility based on which the Government of the Republic of Croatia (hereinafter: Croatia) sets up and implements fiscal policy.

The basic purpose of the Commission's activity is to discuss and evaluate fiscal rules defined in accordance with EU rules. In this regard, the Commission's fundamental tasks

[1] *The new FRA came into force on 1 January 2019.*

laid down in the FRA are mainly focused precisely on monitoring the implementation of those rules, and include:

- examining and assessing the risks of applying the fiscal rules in mid-term budgetary documents and the annual report on the execution of the budget,
- examining and comparing macroeconomic and budgetary projections indicated in mid-term budgetary documents with the most recent available projections of the European Commission (hereinafter: EC),
- monitoring the fulfilment of the recommendations of the Council of the European Union for the purpose of resolving the situation of an excessive budgetary deficit and public debt,
- identifying the occurrence of a disaster, that is, the existence of major economic disruptions with a significant impact on the balance of the general budget, due to which the application of the fiscal rule is temporarily postponed under the condition that fiscal sustainability in the mid-term is not jeopardized, and
- producing an opinion to the Government of the Republic of Croatia on the temporary postponement of the application of fiscal rules in case of extraordinary circumstances.

The Commission is composed of the chairperson and six members elected for a five-year term by the Croatian Parliament. The chairperson is elected through a public call, and the six members are elected from among prominent scientists and professionals at the proposal of the State Audit Office, Institute of Economics in Zagreb, Institute of Public Finance, the Croatian National Bank and faculties of economics and law of the universities in Zagreb, Split, Osijek and Rijeka.

Pursuant to the transitional provisions of the FRA, in its most recent term, from the first constitutive[2] session held on 24 September 2019 until the election of its new chairperson, the Commission was headed by the chairwoman of the Croatian Parliament's Finance and Central Budget Committee, Mrs Grozdana Perić. However, after three failed election attempts, on 12 November 2021, the Croatian Parliament elected and appointed Prof. Sandra Krtalić, PhD from the University of Pula, the first chairwoman of the Fiscal Policy

[2] *Reference to the Commission's constitutive session pursuant to the Fiscal Responsibility Act from 2018 (OG 111/18)*

Commission. With the appointment of the chairwoman, the process of electing the members of the FPC was completed since the other six members, nominated by independent institutions, had already been appointed since 12 July 2019.

The members of the Commission are:

- Prof. Sandra Krtalić, PhD, President of Fiscal Policy Commission
- Maroje Lang, PhD, representative of the Croatian National Bank, Vice President of Fiscal Policy Commission[3]
- Vesna Kasum, MSc, representative of the State Audit Office
- Maruška Vizek, PhD, representative of the Institute of Economics, Zagreb
- Vjekoslav Bratić, PhD, representative of the Institute of Public Finance
- Associate prof. Domagoj Karačić, PhD, Faculty of Economics, University of Osijek, from among the representatives of faculties of economics, and
- Assistant prof. Zoran Šinković, PhD, Faculty of Law, University of Split, from among the representatives of faculties of law.

After the election of the chairperson in late 2021, the Commission started working on establishing itself as an independent and functioning body, and the first session of the Commission presided by prof. Sandra Krtalić, PhD, was held on 24 November 2021.

The Commission was entered in the Register of Business Entities and started working on the amendments to the existing Rules of Procedure. On 2 December 2021, at the technical meeting with the newly appointed chairperson, the Commission agreed on the activities to be undertaken in 2022 in connection with the establishment of an independent and autonomous Commission Office. Pursuant to the transitional provisions of the FRA, administrative and technical works will be carried out by the Service for General Affairs of the Croatian Parliament and the Government of the Republic of Croatia until further notice.

In 2021, the Commission continued performing its tasks under the Fiscal Responsibility Act, primarily in regard to the evaluation of macroeconomic projections and fiscal rules from the budgetary documents of the Government of the Republic of Croatia it had

[3] *Pursuant to Article 17(5) of the FRA, the members of the Commission elected Mr. Lang deputy chairperson of the FPC*

published in its position papers. After several years i of economic growth, during which the condition of Croatian public finances actually improved, in 2020, the Covid-19 pandemic broke out and caused a major economic decline in Croatia. The economic recession was caused, among others, by the implemented measures, the closing of economic activities and the lockdown to restrain the pandemic and the spreading of the CoV-SARS-2 virus. These unfavourable trends continued in 2021 only partially: economic activity recovered completely in the end. A factor contributing to such trends were fiscal policy countercyclical measures during the pandemic as they helped alleviate the effects of the pandemic on Croatian people and economy and contributed to a quick recovery.

To ensure mid- and long-term sustainability of public finances, in its 2021 position papers, the Commission consistently and firmly stressed the need to:

- closely monitor economic and budgetary accomplishments and a timely reaction of the economic policy in case of major deviations;
- streamline and change the activities originally foreseen in the state budget and other financial plans for 2021 so as to utilize the limited fiscal potential for financing the necessary measures to fight the consequences of the outbreak;
- foresee temporary, targeted and efficient fiscal policy measures aimed at alleviating the consequences of the outbreak, which are also necessary due to high public debt and a low rate of potential growth, and
- implement radical changes and attract investments that enable enhanced growth in the future, focusing on utilizing European Union (hereinafter: EU) funds as well and as quickly as possible and directing them toward sustainable projects contributing to future economic growth.

To facilitate such a fiscal policy response, at the level of the EU, the application of fiscal rules was temporarily postponed in 2020, and is to remain postponed in 2022. Back in March 2020, the Commission supported the postponement of the application of the fiscal rules in 2020, and in November 2020, that is, in 2021, it maintained the recommendation to postpone the application of the fiscal rules for 2021 and for 2022. Nevertheless, in its position papers, the Commission repeatedly stressed that the implemented measures must not be of permanent character, and that as soon as the first signs of economic recovery are seen, enhanced fiscal consolidation should be launched.

Furthermore, during 2021, the Commission intensified its international activities within the framework of the EU Independent Fiscal Institutions Network and the EU Independent Fiscal Institutions.

2. Sessions and position papers of the Fiscal Policy Commission in 2021

During 2021, the Commission continued its work in accordance with the transitional provisions and the tasks laid down in Article 22 of the FRA. Since the application of fiscal rules was temporarily postponed in 2021, the Commission focused on its other task, referred to in Article 22 of the FRA, that is, examining and comparing macroeconomic and budgetary projections from mid-term budgetary documents with the latest available EC projections. However, in the comments to those documents, the Commission also aimed to evaluate all those documents, primarily from the perspective of ensuring fiscal liability, that is, examining and assessing the risks of applying fiscal rules in mid-term budgetary documents and the annual report on the execution of the budget. Since macroeconomic projections are an integral part of budgetary documents, the Commission examined both tasks in unified position papers focused on, analysing particular budgetary documents.

Commission's position papers were distributed to the members of the Finance and Central Budget Committee before their discussion on budgetary documents, and the members of the Committee were informed on a given position personally by the Committee's chairwoman who was also the chairwoman of the Commission until 9 November 2021.

Following its fourth task laid down in Article 22 of the FRA, the Commission also provided the Government of the Republic of Croatia with its opinion on the postponement of the application of the fiscal rules in 2022. The Commission published this opinion in its Position Paper[4] on the Draft State Budget for 2022.

[4] *https://www.sabor.hr/sites/default/files/uploads/inline-files/15_stajaliste_PFP.pdf*

2.1. The schedule of Commission sessions and meetings in 2021

In 2021, the Commission held four (4) sessions at which it adopted six (6) position papers published on the Commission's (temporary) website[5]. The agendas of all four Commission sessions are listed below:

7th session of the Fiscal Policy Commission held on 7 June 2021

- *Report on the work* of the Fiscal Policy Commission in 2020
- *11th Position Paper* on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2020
- *12th Position Paper* on the Convergence Programme for 2022-2024 and the Draft Amendments to the State Budget of the Republic of Croatia

8th session of the Fiscal Policy Commission held on 21 September 2021

- *13th Position Paper* on the Draft Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the first semester of 2021 and the Guidelines for the Preparation of the State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024

9th session of the Fiscal Policy Commission held on 2 November 2021

- *14th Position Paper* on the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans for Extra-Budgetary Users for 2021

10th session of the Fiscal Policy Commission held on 24 November 2021

- *15th Position Paper* on the Draft State Budget of the Republic of Croatia for 2022 and the projections for 2023 and 2024

Besides the sessions themselves, on 2 February and 3 December 2021, the Commission also held two working meetings discussing the annual work programme for 2021 and the institutional structure and work of the Fiscal Policy Commission.

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[5] *www.sabor.hr/hr/pregled-stajalista-povjerenstva-za-fiskalnu-politiku*

Most of the sessions and meetings were held in person on the premises of the Croatian Parliament, except for the meeting of 2 February 2021and the session of 24 November 2021 which were held online.

Table 1. List of budgetary documents of the Government of the Republic of Croatia and the related position papers of the Commission in 2021

Budgetary document of the Government of the Republic of Croatia		***Commission evaluation***	
29 April	*Convergence programme of the Republic of Croatia for 2022-2024*	*7 June*	*7th session, 12th Position Paper*
20 May	*Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2020*	*7 June*	*7th session, 11th Position Paper*
2 June	*Draft Amendments to the State Budget for 2021*	*7 June*	*7th session, 12th Position Paper*
29 July	*Guidelines for the Preparation of the State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024*	*21 September*	*8th session, 13th Position Paper*
9 September	*Draft Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2021*	*21 September*	*8th session, 13th Position Paper*
28 October	*Draft Amendments to the State Budget of the Republic of Croatia for 2021*	*2 November*	*9th session, 14th Position Paper*
28 October	*Draft State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024*	*24 November*	*10th session, 15th Position Paper*

Source: Government of the Republic of Croatia, Fiscal Policy Commission.

2.2. Timeline of Commission's activities with highlights

This part presents a short overview of the Commission's positions and conclusions from its sessions and meetings. The activities are listed chronologically and linked to the adopted positions on budgetary documents discussed by the Commission in 2021. The texts of the position papers can be found in the Enclosure.

The Commission Work Programme for 2021

At the meeting held on 2 February 2021, the Commission Work Programme for 2021 was established. The programme takes into consideration the special circumstances due to the pandemic and temporary postponing of the application of fiscal rules in 2021.

11th Position Paper on the Execution of the State Budget for 2020

At its 7th session held on 7 June 2021, the Commission discussed the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2020 and published its conclusions in the 11th Position Paper (see Enclosure). The summary of the position was as follows:

The pandemic had a very negative impact both on the revenue budget (significant decrease of income) and on the expenditure budget (significant increase in expenditure related to the fight against the pandemic). However, considering the extraordinary situation with the pandemic which demanded extraordinary fiscal efforts, the Commission is of the opinion that the fiscal trends achieved in 2020 were unavoidable, and that the resulting state budget deficit was necessary. The Commission came to the conclusion that the Government should have prepared and published the report on the implementation of fiscal rules and analysed the structural deficit trends despite the temporary postponement of the application of fiscal rules in 2020, but failed to do so.

12th Position Paper on the Convergence Programme for 2022-2024 and the first Amendments to the State Budget

At the same session held on 7 June 2021, the Commission also discussed the Convergence Programme for the period 2022-2024 and the (first) Draft Amendments to the State Budget for 2021. The summary of the position was as follows:

The Commission supports the continued application of short-term, targeted measures necessary for alleviating the consequences of the pandemic, and highlights the need to avoid adopting any measures with a permanent negative effect on public finances. Macroeconomic projections indicate a quick recovery, but the Commission stresses that, without strong reforms aimed at increasing potential growth, Croatia might soon be faced with limited *economic growth. Therefore, the expected recovery and discontinuance of crisis measures must be used for a stronger consolidation of public finances starting as early as 2022.*

13th Position Paper on the Semi-Annual Report on the Execution of the State Budget for the First Semester of 2021 and Economic and Fiscal Policy Guidelines for 2022 – 2024

At its 8th session held on 21 September 2021, the Commission discussed the Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the first semester of 2021 and the Economic and Fiscal Policy Guidelines for the period 2022 – 2024 The summary of the position was as follows:

The fiscal measures undertaken to alleviate the consequences of the pandemic contributed to the trends achieved in 2021 which indicated a faster recovery than projected beforehand. The Commission calls on the Government to adjust its growth projections in the preparation of the draft budget for 2022 to the latest trends, and to avoid adopting measures with a permanent negative effect on public finances. The Commission warns that, in a situation of expected continuation of growth, Croatian economy might soon be faced with the limitations resulting from a low rate of potential growth that needs to be intensified through reforms and investments. Therefore, the expected recovery and discontinuance of crisis measures must be utilized, starting already in 2022, for a stronger consolidation of public finances, and full implementation of fiscal rules must be ensured starting with 2023.

14th Position on the second Amendments to the State Budget

At its 9th session held on 2 November 2021, the Commission discussed the (second) Draft Amendments to the State Budget for 2021. The summary of the position was as follows:

The Draft Amendments to the State Budget for 2021 foresee an increase of the general government deficit and of the public debt in 2021 as a result of the countercyclical fiscal policy whose objective is to fight against the epidemic and its economic consequences. The Commission agrees with these Draft Amendments, but, as many times before, stresses that it is necessary to plan and control expenditures better, especially in the healthcare system.

15th Position Paper on the Draft State Budget for 2022 and the Projections for 2023 and 2024

At its 10th session held on 24 November 2021, the Commission discussed both the Draft State Budget for 2022 and the projections for 2023 and 2024. In addition to evaluating the Draft State Budget, the Commission adopted an opinion in which it upheld the proposal to continue the postponement of the application of fiscal rules in 2022 as well. The summary of the position was as follows:

> *The Fiscal Policy Commission supports the Draft State Budget for 2022, the year in which fiscal rules will still not be applied. The Commission warns that there is a risk that expenditures in certain categories will be exceeded, and reiterates that the period of intense growth should be used for enhanced fiscal consolidation. The key to fiscal sustainability is a strong economy which requires reforms and investments, relying on financial resources from the available EU funds.*

3. Commission's publicity of action

The Commission's publicity is mainly achieved in the manner laid down in Article 23(4) of the FRA which stipulates that the Commission shall inform the public on the positions adopted during the performance of its tasks referred to in Article 22 of the FRA by posting on the Commission's website. Pursuant to the transitional provisions, until 12 November 2021 and the election of the new chairperson, the Commission was established as the "second" working body within the framework of the Croatian Parliament, due to which the Commission's website was also part of the Croatian parliament's website at *https://www.sabor.hr/en/committees/commission-fiscal-policy-10-term*.

After 12 November 2021 and the election of the new chairperson, the Commission ceased to be an active working body of the Croatian Parliament and became an independent body. However, in accordance with the transitional provisions of the FRA and until its own website was launched, the Commission continued using the same website as an "inactive" working body. In early 2022, the Commission registered its own domain at *www.pfp.hr* which is to be used for the publication of its position papers and other documents after creating its own website in 2022.

To enhance the visibility of its position papers and to inform the public on its work, the Commission informed the public of its positions through publications issued by the Croatian News Agency (HINA) which were also often published by other media. The Commission did not directly take part in public media through other forms of media exposure.

4. International cooperation

The Commission regularly takes part in meetings of the EU Network of Independent Fiscal Institutions (EUNIFI) headed by the EC, and it is also a member of the EU Independent Fiscal Institutions. At international conferences or meetings on the topic of fiscal responsibility, the Commission is represented by the deputy chairperson or delegated member(s) of the Commission.

In 2021, the EC organized two video conferences of the EU Network of Independent Fiscal Authorities. At the 14th meeting held on 11 March 2021, the participants discussed the EC Communication on fiscal policy, the proposal of the European Fiscal Board on the amendments to the Stability and Growth Pact, the importance of having media cover the following of the fiscal rules as well as resilience and recovery plans. At the 15th meeting held on 23 September 2021, the participants discussed the evaluation of the suitability of fiscal policy in 2022, the Spring Fiscal Package, fiscal risk due to climate change and natural disasters, and public investments.

The Commission's representatives also participated in workshops on possible amendments to the fiscal rules and the new role of independent fiscal bodies organized by the EC as part of the presentation of the process of reviewing and reforming the economic governance system in the EU.

EU Independent Fiscal Institutions held two meetings in 2021. The topic of the meeting held on 25 March 2021 were the activities of the EUNIFI in the preceding period and the work programme for 2021. The participants agreed to prepare joint working material on the reform of the economic governance system and established a working group for ensuring the efficiency of independent bodies with included subgroups in charge of the institutional aspects, forecasting, modelling and the production gap, as well as media visibility. At the meeting held on 30 September 2021, the discussion revolved around EUNIFI's administrative department, the activities of the working groups and the preparation of the seminar. Throughout the year, EUNIFI organized workshops on the inclusion of green investments in the budget planning process and the application of a common production gap evaluation methodology. The representatives of the Commission have actively taken part in EUNIFI's working groups.

The Commission has also regularly met with the representatives of the EC (16 March 2021) and the International Monetary Fund (17 June 2021).

5. Financial Statement

In 2021, the Commission did not use the planned budgetary resources because it was only constituted in the present form in late 2021 when its chairperson was elected. The members of the Commission were paid their fees and travel expenses from the category "010 Croatian Parliament". Almost all of the budgetary resources planned for 2021 were returned to the state budget, except for those expended for:

1) Covering the costs of business trips in the amount of HRK 1,228.00 (to cover the expenses of the Commission's chairwoman trip from Pula to Zagreb for official purposes);
2) Office supplies and other tangible expenditure in the amount of HRK 625.00 (purchase of the stamp);
3) Office equipment and furniture in the amount of HRK 22,979.00 (purchase of one MacBook Pro) and
4) Communication equipment in the amount of HRK 4,199.00 (purchase of one mobile phone).

Table 2 2021 Fiscal Policy Commission budget

DESCRIPTION	PLAN FOR 2021	FINAL PLAN FOR 2021	**EXECUTION IN 2021**
Total personnel expenses	1,101,800.00	0.00	0.00
Total compensation of costs to employees	29,500.00	19,500.00	1,228.00
Total expenses for material and energy	15,000.00	15,000.00	625.00
Total expenses for services	100,100.00	100,100.00	0.00
Total compensation of costs to non-employees	30,000.00	20,000.00	0.00
Total other business expenses, not mentioned elsewhere	155,000.00	24,000.00	0.00
Total other financial expenses	700.00	700.00	0.00
Total plants and equipment	21,000.00	21,000.00	4,199.00
TOTAL ADMINISTRATION AND MANAGEMENT	**1,453,100.00**	**200,300.00**	**6,052.00**
Total intangible assets	6,000.00	6,000.00	0.00
Total plants and equipment	30,000.00	30,000.00	22,979.00
Total intangible assets produced	10,000.00	10,000.00	0.00
TOTAL INFORMATIZATION	**46,000.00**	**46,000.00**	**22,979.00**
OVERALL TOTAL	**1,499,100.00**	**246,300.00**	**29,031.00**

Source: State Budget of the Republic of Croatia for 2021. Service for General Affairs.

6. Enclosures: Position Papers of the Fiscal Policy Commission for 2021

6.1. 11th Position Paper of the Croatian Parliament Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for the year 2020

At its 7th meeting held on 7 June 2021, the Fiscal Policy Commission (hereafter referred to as: the Commission) discussed the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for the year 2020, submitted to the Speaker of the Croatian Parliament by the Government of the Republic of Croatia (hereafter referred to as: the Government) on 20 May 2021.

In the year 2020, the pandemic had a significantly negative impact on both the revenue side (significant revenue reduction) and the expenditure side of the budget (strong increase in expenditures related to the fight against the pandemic). However, given the extraordinary situation of the pandemic, which necessitated exceptional fiscal efforts both globally and in the Croatian economy, the Commission considers that the fiscal developments in 2020 and the state budget deficit could not have been avoided. In addition, despite the temporary postponement of the implementation of fiscal rules in 2020, the Commission is of the opinion that the Government should prepare and publish a Report on the Implementation of Fiscal Rules and analyse the development of the structural deficit, which has not been done.

Since the beginning of 2020, the world and the Croatian economy have been facing the trying circumstances of the COVID-19 outbreak. Strong support from public finances has been required to mitigate the negative consequences of the pandemic and stimulate aggregate demand. As a result, in March 2020, the Council of the European Union activated the general escape clause of the Stability and Growth Pact in order to provide fiscal stimulus to the Member States. The Croatian Fiscal Responsibility Act (hereinafter: ZFO) provides for a temporary postponement of the application of fiscal rules in case of extraordinary circumstances, provided that in accordance with EU rules this does not jeopardize fiscal sustainability in the medium term. In accordance with the recommendation of the Fiscal Policy Commission of 30 March 2020, on 2 April 2020 the Government adopted a Decision on the temporary suspension of the application of fiscal rules (official gazette *Narodne novine* no. 41/2020) referred to in Articles

6, 7 and 8 of the ZFO, temporarily suspending the application of numerical fiscal rules. The benchmarks – the budget deficit limit of 3% of gross domestic product and the public debt of 60% and/or on a declining trajectory – are still in force. If the European Commission (hereinafter: EC) considers that there is a risk that these criteria are not met, it is obliged to regularly assess and report thereon to the Council of the European Union. On 20 May 2020, the EC prepared a Report in accordance with Article 126(3) of the Treaty on the Functioning of the European Union[6], in which it identified a probable excess of the deficit criterion in 2020 and concluded that it was exceptional and temporary, which is why no corrective procedures were initiated. Moreover, the Council of the European Union, in its Specific Recommendations of 20 July 2020[7] recommended that the Republic of Croatia "take all necessary measures, in line with the general escape clause of the Stability and Growth Pact, to effectively address the COVID-19 pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment."

The aim of fiscal rules is to provide sufficient space to run counter-cyclical fiscal policy in order to facilitate measures aimed at providing assistance to people and the economy in times of economic crisis. The trends and fiscal consolidation achieved in the Republic of Croatia over the last few years, membership in the European Union, and preparations for joining the euro area have provided additional fiscal space and helped the Croatian economy during the first months of the pandemic. However, Croatia's fiscal policy is limited by a high level of public debt and a low rate of potential growth. In such circumstances**, it is necessary to consistently follow the provisions related to the postponement of the application of fiscal rules, while ensuring that the fiscal measures taken are short-term, effective and aimed at combating the consequences of the epidemic.**

The COVID-19 outbreak has hit the Croatian economy and public finances hard: compared to 2019, in 2020 general government revenues were nominally reduced by 6.5%. The

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[6] Report by the European Commission under Article 126(3) of the Treaty on the Functioning of the European Union (COM(2020) 547), available at https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/com-2020-547-hr_en.pdf.

[7] Council recommendation of 20 July 2020 on the 2020 National Reform Programme of Croatia and delivering a Council opinion on the 2020 Convergence Programme of Croatia (2020/C 282/11), available at https://eur-lex.europa.eu/legal-content/HR/TXT/PDF/?uri=CELEX:32020H0826(11)&from=EN.

largest decline in revenues was recorded in tax revenues, mostly due to the decline in revenues from value added tax (13.4%). There was also a smaller decline in labour market-related revenues – income taxes and contributions – but this decline was not as significant due to fiscal measures introduced by the Government. Thus, the decline in income tax revenues amounted to 6.0%, and from contributions to 4.8%. At the same time, general government expenditures increased by as much as 8.6% as a result of planned and undertaken activities that increased public spending, and special measures related to combating the effects of the pandemic.

State budget revenues in 2020 amounted to 131.6 billion HRK, which is by 8.3 billion HRK (6.0%). lower compared to 2019. Tax revenues were significantly reduced, by 9.5 billion HRK (11.6%), mostly due to the decline in value added tax revenues as a result of the drop in personal consumption. In contrast, aid revenues, which mostly relate to funds from the European Union, were by 3.4 billion HRK or 22.9%. higher than the year before.

State budget expenditures in 2020 amounted to 153.5 billion HRK and are by 13.6 billion HRK or 9.8% higher than in 2019. Subsidies increased significantly compared to 2019 and this due to the implementation of measures to preserve jobs with employers whose businesses were disrupted due to the epidemic. In total, in 2020, the state budget financed expenditures related to the epidemic in the amount of 10.7 billion HRK. In addition to the above, various measures related to the epidemic in the amount of 5.4 billion HRK were financed from the state budget.

Finally, in 2020, state budget expenditures exceeded revenues by 21.9 billion HRK and the deficit is financed by new borrowings. Due to lower revenues and the need to finance higher state budget expenditures due to the epidemic, at the end of 2020 the state budget debt increased by 32.7 billion HRK or 13.3% compared to 2019[8].

Such developments have also led to an increase in the general government deficit[9], which in 2020 amounted to as much as 7.4% of GDP. Of this, the central government budget deficit amounted to 6.4% of GDP, and a significant deterioration was also recorded in the local

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8 Annual Report on the Execution of the State Budget of the Republic of Croatia for the year 2020. Available at https://vlada.gov.hr/UserDocsImages/2016/Sjednice/2021/Svibanj/58%20sjednica%20VRH/58%20-%205.pdf

9 According to the Central Bureau of Statistics April 2021 Report on the Excessive Budget Deficit Procedure and the General Government Debt Level. Available at https://www.dzs.hr/Hrv_Eng/publication/2021/12-01-02_01_2021.htm.

government sector (deficit of 1.0% of GDP), which, in addition to the negative effects of the pandemic, was also affected by changes in the income tax system.

Although fiscal rules were temporarily postponed in 2020, the Government should have but again failed to **prepare a Report on the Implementation of Fiscal Rules and to analyse the developments of the structural deficit.** Despite the uncertainty that strongly affects the assessment of the potential product, the output gap and thus the structural balance, the provisions of the Stability and Growth Pact do not suspend the application of procedures, but only allow departure from the numerical values of the necessary adjustment of the structural balance towards the medium-term budgetary objective. **Therefore, the Commission considers that the Government, when preparing budget documents, must make and publish such analyses and calculations.**

The calculations cited in the EC Spring Forecast from May 2021[10] show that, according to the standard calculation methodology, in 2020 the output gap in the Republic of Croatia was as high as -5.5%. The cyclical impact of the pandemic on the deficit was -2.4% of GDP, while the structurally adjusted balance was -5.0% of GDP. The large increase in the structural balance of 3.6% of GDP compared to the pre-pandemic levels in 2019 can be fully explained by the impact of fiscal measures to combat the consequences of the pandemic. According to the calculations presented in the Convergence Programme 2022-2024[11], the total amount of fiscal effects of COVID-19 measures in 2020 was 3.8% of GDP. This means that the structural balance, if these measures were to be excluded, would have remained at a level similar to 2019. Although at the time the Commission considered that a faster and stronger reduction of the structural balance and public debt was needed, it is of the opinion that **the fiscal developments in 2020 could not have been different and that the run deficit was necessary to reduce the negative consequences of the pandemic.**

The large economic downturn and budget deficit have led to a large increase of the debt-to-GDP ratio. Thus, the general government debt in 2020 increased by 329.7 billion HRK, which is an annual increase of 36.8 billion HRK. Due to the large nominal decline in GDP, the

[10] Available at https://ec.europa.eu/info/sites/default/files/economy-finance/ip149_en.pdf.

[11] Available at https://ec.europa.eu/info/sites/default/files/2021-croatia-convergence-programme_hr.pdf

public debt situation is significantly worse when viewed as a share of GDP. Thus, public debt increased from 72.5% of GDP at the end of 2019 to as much as 88.7% of GDP at the end of 2020.

Budget deficit of 7.4% of GDP and the large increase in public debt to as much as 88.7% of GDP in 2020 significantly exceed the reference values of the Stability and Growth Pact, and both criteria of public finances were exceeded. Therefore, on 2 June 2021, the EC published a Report under Article 126 (3) of the Treaty on the Functioning of the European Union. It found that the excess of the deficit over the reference value was exceptional because it stemmed from exceptional circumstances, but was not close to the 3% of GDP reference value. In addition, based on the projection for 2021 and 2022 in which the expected deficit would again exceed 3%, it concluded that the excess was not temporary. Public debt also exceeded 60% of GDP, and in 2020 it was not reduced as prescribed. Despite the fact that both criteria were exceeded, the EC again decided not to initiate the excessive deficit procedure (the 'corrective arm').

The Commission considers that such a significant deterioration in public finances in the first pandemic year 2020 was necessary to facilitate a countercyclical fiscal policy aimed at mitigating the short- and medium-term consequences of the pandemic, yet stresses the need to closely monitor the situation and economic developments. It is of the opinion that in the event of a faster-than-expected economic recovery, it is necessary to stay on the path of fiscal consolidation embarked before the crisis. In this regard, it is crucial to follow the recommendations of the Commission, the EC and the European Council on the nature of fiscal measures and to refrain from other expansionary measures that could jeopardize the medium- and long-term sustainability of public finances.

6.2. 12th Position Paper of the Fiscal Policy Commission on the Convergence Programme 2022-2024 and the Proposal of Amendments to the State Budget of the Republic of Croatia

At its 7th meeting held on 7 June 2021, the Fiscal Policy Commission (hereinafter: Commission) discussed the Convergence Programme of the Republic of Croatia for 2022-2024, that was adopted by the Government of the Republic of Croatia (hereinafter: Government) on 29 April 2021, and the Proposal of Amendments to the State Budget of the Republic of Croatia and extra-budgetary users' financial plans for the year 2020, submitted to the Speaker of the Croatian Parliament by the Government of the Republic of Croatia by an act of 2 June 2021.

The Commission supports the continuation of short-term and targeted measures necessary to mitigate the effects of the pandemic, stressing the need to avoid the adoption of measures with a lasting negative impact on public finances. Macroeconomic projections point to a rapid recovery, but the Commission emphasizes that without strong reforms aimed at increasing potential growth, Croatia could very quickly face limited economic growth. Therefore, the expected recovery and lifting of crisis measures need to be used for stronger consolidation of public finances as early as 2022.

For the second year in a row, the world and Croatian economies are threatened by the COVID-19 pandemic, which necessitates increased funding for health interventions and other measures to mitigate the economic and social consequences of the pandemic, including supporting recovery and increasing economic resilience.

The provisions of the Fiscal Responsibility Act (hereinafter: ZFO) and the Stability and Growth Pact (hereinafter: SGP) provide for situations in which it is possible to derogate from numerical rules in order to adequately respond to adverse events beyond the control of Member States, but provided that the medium- and long-term sustainability of public finances is protected. Accordingly, at its session held on 2 April 2020, at the invitation of the Commission, the Government adopted a Decision on the temporary postponement of the application of fiscal rules, by which, in accordance with Article 10 of the ZFO and EU rules (hereinafter: EU), the implementation of the numerical fiscal rules referred to in Articles 6, 7, 8 and 9 is postponed. At the same time, the Council of the EU, on the recommendation of the European Commission (hereinafter: EC), activated the general escape clause. The general clause at EU level allows Member States a budget deficit that does not have to follow the amounts projected towards the medium-term budgetary objective but may temporarily exceed the set levels.

Other procedures from the SCG are still active, including the quantitative criteria for budget deficit and public debt. Already in May 2020, in its Report under Article 126(3) for the Republic of Croatia[12], the EC warned that the deficit criterion will be exceeded, but upon consultation with the Council of the EU it concluded that due to the high level of uncertainty and the necessary support to the economy it would not activate any corrective procedures. The EC took the same position in June 2021, establishing that the deficit and public debt criterion had been exceeded.[13] In the country-specific recommendations addressed to the Member States of July 2020, the Council of the EU[14] recommended that necessary fiscal support to address the impacts of the pandemics should be ensured, first of all in the form of targeted and temporary measures, and stressed the need to return to the path of sustainability of public finances and the path of sustainable growth. The same messages for 2021 were conveyed by the Executive Vice President of the EC and the Commissioner for the Economy in their letter[15] in September.

In March 2021, the EC issued guidelines[16] for the development of stability and convergence programmes according to which fiscal support for recovery is still needed. Fiscal support measures should be timely, temporary and targeted, and once health risks have diminished, the fiscal measures should gradually pivot to more targeted measures that promote a resilient and sustainable recovery. Given the lack of fiscal capacity, it is necessary to rely more heavily on funds from the Recovery and Resilience Facility. This position was reiterated by the EC in the European Semester Spring Package from June 2021[17], and it confirmed that the general escape clause is expected to be deactivated as of 2023.

[12] Available at: https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/com-2020-547-hr_en.pdf

[13] Communication on the economic policy coordination in 2021. COM(2021)500. Available at: https://eur-lex.europa.eu/legal-content/HR/TXT/?uri=CELEX%3A52021DC0500&qid=1623048563205

[14] Country-specific recommendations for Croatia (ST 8184/20 - COM(2020) 511) available at: https://data.consilium.europa.eu/doc/document/ST-8430-2020-INIT/hr/pdf

[15] Available at: https://ec.europa.eu/info/sites/default/files/economy-finance/hr.pdf

[16] Communication from the Commission to the Council: One year since the outbreak of COVID-19: fiscal policy response (COM(2021)105). Available at: https://eur-lex.europa.eu/legal-content/HR/TXT/HTML/?uri=CELEX:52021DC0105&from=EN

[17] Read more about the Spring Package at: https://ec.europa.eu/commission/presscorner/detail/hr/IP_20_901.

Since the declaration of the epidemic in March 2020, the Fiscal Policy Commission has been supporting the Government's activities in addressing the consequences of the epidemic. It reminds that even in the conditions of postponing the application of fiscal rules, there are still restrictions in conducting fiscal policy. The Commission therefore recommends the following:

- targeted and short-term measures should be adopted, which do not jeopardize the sustainability of public finances;
- high public debt in conditions of low potential growth significantly limits the possibility of using fiscal policy, so it is necessary to use as much as possible the funds from the Recovery and Resilience Facility (hereinafter: RRF);
- measures aimed at increasing the potential growth of the Croatian economy, such as public investment and reforms, contribute the most to fiscal sustainability;
- the decision to temporarily postpone the application of fiscal rules should be constantly reviewed and revoked once the crisis is over.

In addition, when delivering its position on the Draft Budget for 2021, the Commission concluded that, according to the projections at the time, the requirements for postponing the application of fiscal rules in 2021 were met. However, although the EC concluded on the basis of its Spring Forecast that the application of the general escape clause could be maintained in 2022, the Commission will issue its opinion and recommendation to the Government in autumn 2021 on possible repeal of the Decision on temporary postponement of fiscal rules in 2022.

Macroeconomic projections

The Commission assesses macroeconomic and budgetary projections based on an assessment of their credibility, i.e. realism, and their comparison with the latest available EC projections. As the Convergence Programme and the Proposal of Amendments to the State Budget for 2021 are based on a single and identical macroeconomic and fiscal projection, the Commission assessed them jointly in this position paper.

Macroeconomic projections are based on better-than-expected expectations, with a simultaneously accelerating economic recovery. Despite such trends, the Croatian economy will not return to pre-pandemic levels until next year, 2022, which also influences the conclusion that fiscal support needs to continue. With the expected normalization of the health situation, a large contribution to growth is expected from RRF funds, on the basis of which an additional contribution to growth of 0.3% in 2021, 1.4% in 2022, 1.4% in 2023 and 0.9% in 2024 is predicted. With such assumptions, the Government predicts that GDP will grow by 5.2% in real terms in 2021, 6.6% in 2022, 4.1% in 2023 and 3.4% in 2024. However, in the conditions of low potential growth, this will also mean a very fast closing of the production gap, which will lead to a number of restrictions on the continuation of such high growth.

Furthermore, the ZFO requires that macroeconomic projections must be aligned with EC projections. However, the growth projections expected by the EC are somewhat lower and amount to 5.0% in 2021 and 6.1% in 2022, while they also expect significantly slower rise in deflators. In other words, the Government expects higher real growth than the EC projections by 0.2% in 2021 and 0.5% in 2022, while the deviation of nominal growth is even larger and amounts to 0.6% in 2021. and 1.2% in 2022.

With all this in mind, the Commission considers that, despite the fact that the Government's macroeconomic projections deviate to some extent from the EC projections, they can be achieved in the event of continued current trends and stronger use of RRF funds. The Commission therefore proposes to the Government that when drafting the budget for 2022, it should revise its adjustments in accordance with the achievements during the summer of 2021 and the findings regarding the planned dynamics of RRF withdrawals, and maintain a conservative approach to budget revenue planning.

Convergence Programme

The convergence programme is based on the assumption of a rapid recovery and absorption of RRF funds and contains assumptions on amendments to the budget for 2021, with no major changes to existing policies in the coming period.

The Commission, which in previous position papers called on the Government to temporarily postpone the implementation of tax changes in 2021, especially regarding tax reductions, welcomes the plan to correct the budget deficit during the growth period primarily through slower growth of current spending, while a possible reduction in the tax burden should be pursued only once recovery and consolidation of public finances are achieved.

According to the projections from the Convergence Programme, the general government deficits will be at 3.8% in 2021, 2.6% in 2022, 1.9% in 2023 and 1.5% in 2024. The Commission believes that the projected deficit for 2021 is appropriate to the current situation, but that a strong recovery should be taken advantage of to accelerate the consolidation of public finances and reduce public debt in the coming years.

Despite the recommendation and request of the Commission that even in the conditions of temporary postponement of the application of fiscal rules, budget documents should contain an assessment of the structural deficit that would enable a better overview of the state of public finances, the Convergence Programme does not contain such an analysis. Therefore, the Commission used the EC Spring Forecast, according to which the structural deficit increased from 1.4% in 2019 to 5.0% in 2020, or by 3.6 percentage points. In 2021, the deficit is expected to decrease to 3.2% and 3.3% in 2021. The increase in the structural deficit was mostly influenced by the measures introduced to address the pandemic (3.8% in 2020 and 2.2% in 2021). Given the extraordinary circumstances, the Commission considers it acceptable that these measures have the greatest impact on the development of the structural deficit. However, given that in 2022, despite the lifting of these measures, which exceed the projected increase in public investment, there is no noticeable correction of the structural deficit, the Commission warns that when drafting the budget for 2022 it is necessary to come up with a more ambitious consolidation plan, especially considering the additional interest savings. The expected deactivation of the general escape clause as of 2023 means that public finances should go in the direction of consolidating the deficit towards the medium-term budgetary target of 1% at a rate of at least 0.5 percentage points per annum, which the existing Convergence Programme does not show. It is also necessary to limit the growth of current expenditures well below the expected high real growth rates.

Proposal of Amendments to the State Budget 2021

The proposed amendments to the State Budget for 2021 recognize the stabilization of budget revenues in 2021, but also a further increase in expenditures to finance the fight against the epidemic, increased expenditures for healthcare and support of employees and companies most affected by the crisis with the aim to preserve the economic potential.

A slight increase in state budget revenues in 2021 presupposes a recovery in economic activities, given the effects of tax changes for 2021 and the planned absorption of EU funds. Accordingly, the planned total revenues in 2021 amount to HRK150.3 billion. Increase in budget revenues by HRK 3 billion or 2.1% compared to the previous plan for 2021, primarily refers to assistance from EU funds in the amount of HRK 1.4 billion. Tax revenues are projected to increase by HRK 336.7 million, primarily on the basis of income tax revenues and taxes on goods and services, with a slight decrease in value added tax revenues, as a result of uncertainties related to the tourist season and personal consumption in 2021.

Based on the proposed amendments to the State Budget for 2021 (hereinafter: Amending Budget), total expenditures increased by HRK 9.4 billion (6%) compared to the original plan for 2021, which is a consequence of the redistribution within the budget in order to provide funds for the functioning of the healthcare sector, financing further measures and activities in the fight against the epidemic and providing funds for expenditures for employees in the education sector. Accordingly, the total expenditures in 2021 were originally planned in the amount of HRK 157.9 billion, and the Amending Budget envisages their further increase to HRK 167.3 billion. The largest increase in expenditures in 2021 financed from sources that affect the result of the state budget compared to the State Budget for 2021 is planned for rehabilitation and investments in healthcare (HRK 4.2bn), aid for employees and companies affected by the coronavirus (HRK 2.4bn) and employee expenditure (HRK 1.3bn). The proposed amendments to the State Budget for 2021 reflect the intention for moderate consolidation of public finances, and the Commission proposes to the Government of the Republic of Croatia to evaluate previous and current activities in healthcare and economy to determine their real fiscal effects on economic development. The Commission considers it necessary to assess the future risks of budget expenditures, especially in view of the growing debts of the healthcare system, the public sector wage system or significant contingent liabilities based on issued state guarantees.

The total result will lead to a state budget deficit of HRK 17 billion or 4.3% of GDP. According to the ESA 2010 methodology, the general government will have a deficit of HRK 15.3 billion or 3.8% of GDP.

6.3. 13th Position Paper of the Fiscal Policy Commission on the Draft Semi-Annual Report on the execution of the State Budget of the Republic of Croatia for the first semester of 2021 and the Guidelines for the preparation of the State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024

At its 8th session held on 21 September 2021, the Fiscal Policy Commission (hereinafter: the Commission) discussed the Draft Semi-Annual Report on the execution of the State Budget of the Republic of Croatia for the first semester of 2021, adopted by the Government of the Republic of Croatia on 9 September 2021 and the Guidelines for the preparation of the State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024, which were adopted by the Government on 29 July 2021.

Achieved developments in 2021 point to a faster recovery than previously projected, which was contributed by the fiscal measures taken to mitigate the consequences of the pandemic. The Commission also calls on the Government to adjust its growth projections to the latest developments when drafting the budget for 2022, but also to avoid adopting measures with a lasting negative effect on public finances. The Commission warns that in the face of expected continued growth, the Croatian economy could soon face constraints stemming from a low rate of potential growth that needs to be increased through reforms and investment. Therefore, as early as 2022, the expected recovery and repeal of crisis measures need to be used for stronger consolidation of public finances, and to ensure full implementation of fiscal rules from 2023.

For the second year in a row, the world and Croatian economy is threatened by the COVID-19 pandemic, which necessitated strong funding for health interventions and other measures to mitigate its economic and social consequences, including supporting recovery and increasing economic resilience. To enable this, the provisions of the Fiscal Responsibility Act (hereinafter: FRA) and the Stability and Growth Pact (SGP) have been applied, which allow a temporary deviation from the numerical rules, but with the condition of protecting the medium and long-term sustainability of public finances.

The economic policy measures taken at the national and global level, in the context of growing resistance to coronavirus, primarily through vaccination of the population and improvement of treatment methods, contribute to the gradual normalization of life and accelerated economic recovery. Economic activity is projected to reach pre-pandemic levels as early as 2022, which is why it is necessary to ensure the normalization of fiscal policy and the long-term sustainability of public finances. Due to the high level of public debt and low rates of potential growth of the Croatian economy, it is necessary to start a stronger consolidation of public finances as early as 2022, whereby available funds, especially those from the Recovery and Resilience Facility (hereinafter: RRF), should contribute to economic potential growth and long-term sustainability of public finances. The fiscal rules of the preventive part of the Stability and Growth Pact are designed to ensure that counter-cyclical fiscal policies are pursued in "normal" circumstances. The transition to a "normal" mode of operation in the context of the achieved recovery requires Croatia to abolish fiscal incentives, which could jeopardize the expected growth in the event of a worsening of the epidemic situation. In terms of gradual adjustment and avoiding a sharp tightening of fiscal policy, the European Commission's communication on the continuation of fiscal support and postponement of the numerical fiscal adjustment requirements in 2022[18] should be considered, as well as the announced discussion on their reform. However, despite the temporary postponement of the full application of numerical fiscal rules, the Commission recalls the need to continuously monitor and review the fiscal position and calls on the Government to present an analysis of fiscal rules when presenting budget documents and ensure their compliance in 2023 when fiscal rules will be active again.

Execution of the state budget of the Republic of Croatia for the first semester of 2021

The economic activity of the Republic of Croatia is rapidly recovering and is expected to soon reach pre-pandemic levels. Such developments favour the recovery and growth of budget revenues, which contributes to the reduction of the budget deficit. At the same time, budget expenditures continue to rise, which can be largely related to measures aimed at combating the consequences of the pandemic. In such circumstances, the Commission recalls the need to use

[18] Available at https://ec.europa.eu/info/system/files/com-2021-500_en.pdf.

the recovery for fiscal consolidation by controlling expenditure growth and redirecting it to areas that will contribute as much as possible to potential growth.

According to the State Budget of the Republic of Croatia for 2021 (Amendments to the State Budget of the Republic of Croatia for 2021 from June 2021), total revenues are planned in the amount of HRK 150.2 billion, and in the first half of 2021 they amounted to HRK 74, 1 billion, which is 49.3% of the annual plan. Compared to the same period in 2020, total revenues increased by HRK 13.7 billion or 22.8%.

In the structure of tax revenues in the first half of 2021, HRK 37.5 billion was collected compared to the plan that foresaw HRK 32 billion, which is an increase of 16.9% (46.9% of the annual plan). The most significant growth in tax revenues was recorded in value added tax, profit tax and special taxes and excise duties. Revenues from value added tax in the first half of 2021 amount to HRK 24.6 billion (increase of 19.5% or 45.9% of the annual plan), from income tax of HRK 4.9 billion (increase of 19, 1% or 58.9% of the annual plan), from special taxes and excise duties HRK 7 billion (increase of 8.5% or 44.5% of the annual plan), while revenues from contributions amount to HRK 12.1 billion (increase from 15.9% or 48.4% of the annual plan). The increase in tax and contribution revenues is the result of increased economic activity and increased employment. Furthermore, revenues from aid in the first half of 2021 amount to HRK 12.4 billion (an increase of 19.4%), and relate to projects that are mostly financed from the European Union budget.

Total state budget expenditures in 2021 are planned in the amount of HRK 167.4 billion, and in the first half of 2021 they were made in the amount of HRK 84 billion (50.2% of the annual plan), which compared to the same period in 2020 represents an increase of HRK 6.9 billion or 8.9%.

Operating expenses amounted to HRK 81.9 billion (51.5% of the annual plan) and increased by HRK 7 billion year on year. The most significant increase in expenditures was recorded in the area of health care, where HRK 1.6 billion was allocated for settling part of debts to suppliers and HRK 2.7 billion for transfers to the Croatian Health Insurance Institute. An increase in expenditures was also recorded for employees in the public sector and allocations for pensions, which increased by HRK 1.9 billion year on year.

Despite the fact that part of the due liabilities of the health care system has been settled, these liabilities continue to grow uncontrollably. Also, in some positions, especially expenditures for salaries and pensions, there will not be enough funds and it will be necessary to provide additional funds for their financing.

The difference between the total revenues and expenditures of the state budget in the first half of 2021 amounts to HRK 9.8 billion (2.5% of GDP, or 57.7% of the annual plan). Compared to the same period in 2020, when it amounted to HRK 16.7 billion, the deficit is lower by HRK 6.9 billion. At the general government level, the total deficit amounts to HRK 9 billion (2.3% of GDP or 48% of the annual plan). Given the positive economic trends, the deficit at the level of the entire 2021 could be lower than the planned HRK 18.8 billion (or 4.7% of GDP). Thus, the general government deficit according to the ESA methodology could be slightly lower than the planned 3.8% of GDP in 2021.

Guidelines for the preparation of the state budget for 2022 and projections for 2023 and 2024

The State Budget Guidelines is a document that expands the general budget plan at the general government level presented in the Convergence Program of 29 April 2021 to the national methodology used for state and budgeting of other general government units.

In its 12th Position paper since June 2021, the Commission has assessed the Convergence Program and concluded several things. First, the Commission called on the Government, when drafting the 2022 budget, to revise its corrections in line with the achievements during the summer of 2021 and the expected dynamics of RRF withdrawals, and to maintain a conservative approach to budget revenue planning. Secondly, the Commission reminded that even in the conditions of temporary postponement of the application of fiscal rules, budget documents should contain an assessment of the structural deficit that would enable a better overview of the state of public finances and compliance with numerical fiscal rules from 2023. Third, the Commission warned that when drafting the budget for 2022, it is necessary to come up with a more ambitious consolidation plan given the expected recovery, and limit the growth of current expenditures well below the expected high real growth rates.

Macroeconomic projections

The macroeconomic projections from the 2022 Guidelines were drawn up in March 2021 and did not assume such a strong and rapid recovery of the economy, which in the first half of 2021 grew by 7.5% compared to the same period in 2020, and strong growth continued in third trimester. On the other hand, the projections in the Guidelines are very optimistic about the amount and impact of the use of RRF funds in the next financial period. With such assumptions, the Guidelines predict that GDP will grow in real terms by 5.2% in 2021, 6.6% in 2022, 4.1% in 2023 and 3.4% in 2024.

The FRA requires that macroeconomic projections must be aligned with the European Commission's projections. In July 2021, the European Commission published a new projection[2] in which, based on the data available at the time, it increased the expected growth of the Croatian economy to 5.4% in 2021 and 5.9% in 2022, while expecting significantly slower price growth.

Such projections and trends in the second and third quarters of 2021 indicate that the projections from the Guidelines as well as the European Commission's summer projections are underestimated and need to be updated when drafting the following budget documents (amendments and budget proposals). On the other hand, the Government is optimistic about the projections for the next period, especially if an accelerated recovery is achieved in 2021. In such circumstances, the output gap closes as early as 2022 and Croatia will once again face the constraints of a low rate of potential growth, the increase of which requires the implementation of reforms and additional investment in sources of growth.

The Commission also warns of rising inflation due to rising raw material and producer prices on the international market, which could be further influenced by domestic factors, especially on the labour supply side due to emigration and unfavourable demographic situation. Also, although more efficient withdrawal and spending of RRF funds is desirable due to the greater multiplier effects of spending these funds on GDP and increasing economic potential, their increased use could create additional pressure in sectors such as logistics or construction that are already facing significant supply-side constraints.

Budget projections

Given the necessary adjustments to macroeconomic projections, developments and thus part of the budget lines, the Commission welcomes the continuation of the current practice of conservative planning of budget revenues, which is reflected in a significant reduction in the share of revenues in GDP and decreases from 37.7% of GDP in 2021 to 33.9% in 2024. At the same time, as in previous views, it calls on the Government to evaluate and assess the risks of past and current activities and revenues and expenditures, in particular with regard to tax changes, in order to gain insight into their real fiscal effects.

The proposed projections from the Convergence Program indicate that the planned increase in budget expenditures is less than the potential growth. This approach, which is also contained in the fiscal rules, ensures that fiscal consolidation occurs automatically during the recovery period. Total general government expenditures are declining from 55.4% of GDP, as they were in 2020, to 50.5% in 2024, which is a good direction. However, planned expenditures are still significantly higher than in the pre-pandemic period (47.1% of GDP in 2019). In such circumstances, the Commission considers that additional modalities for limiting expenditure growth need to be sought, and it is important that this consolidation does not jeopardize the reforms and investments necessary to ensure faster growth.

The Commission draws attention to certain difficulties that have been present in recent years in planning expenditures. The health care system continuously records significant losses that need to be covered from the state budget, which was particularly pronounced during the pandemic. In addition, there is a continuous problem of insufficient planning (sub-planning) of necessary expenditures for salaries and pensions, which are regularly adjusted to the rebalances. Finally, the realized price growth could further complicate the planned expenditures and create additional pressure for their growth, especially those related to investments. Although most investments are planned to be financed by EU funds, rising prices and slower dynamics of their implementation could put additional pressure on public spending.

The planned budget indicates that during the planned period there will be a significant reduction in the general government deficit from the expected 3.8% in 2021 to 1.5% in 2024. However, such developments largely stem from the expected recovery and are cyclical in nature. In conditions of a low level of potential growth, the projected growth will lead to a sharp opening of the positive output gap as early as 2022.

The Commission recalls that in the event of expected economic growth in 2023, all conditions for reactivation of numerical fiscal rules will be met, which will require an annual correction of the structural deficit of 0.5 percentage points per year to reach the minimum medium-term budgetary target of -1% of GDP. Although the Commission believes that a sharp fiscal consolidation could jeopardize the recovery, the year 2022 is an opportunity for a significant easing of fiscal support, while in the context of strong growth in the coming years, the ambition should be a stronger fiscal consolidation in accordance with fiscal rules. The Commission warns that the current proposal for the 2022 Guidelines does not meet these requirements and that the consolidation of public finances over the next three years should be more significant in order to meet these conditions.

The Commission recalls that a key factor in fiscal sustainability stems from the growth of economic potential that serves as a basis for financing public spending. The Commission strongly calls for the fastest possible consolidation at all levels and the preparation of as many quality and sustainable projects as possible to withdraw funds to strengthen the economic recovery and resilience, but sees the challenges in existing capacities and the will to implement much-needed structural reforms within the entire public sector, especially in health, public administration and education, but also in other sectors. The government must insist at all levels and make every effort to, on the one hand, clearly and unequivocally embark on much-needed reforms and increase the efficiency of public spending and, on the other hand, attract as much EU funding as possible. The focus must be on projects that will bring the greatest added value to the economy and contribute to the growth of potential GDP, which will certainly have an impact on increasing the fiscal sustainability of the domestic economy.

The importance of economic growth for fiscal sustainability is best reflected in the evolution of the public debt-to-GDP ratio. During these two pandemic years, this ratio rose sharply both to secure the necessary fiscal support during the recession and to fall in the baseline. In the conditions of the expected economic boom, it is expected to decrease from 88.7% in 2020 to 86.6% in 2021, 82.5% in 2022, 79.5% in 2023 and 76.8% in 2024. . The expected reduction of this ratio in the three-year budget period is almost 10 percentage points or over 3 percentage points per year, which will achieve the fiscal rule of debt. However, the debt ratio will continue to be significantly higher than before the pandemic, and continued efforts will be needed to ensure fiscal sustainability.

6.4. 14th Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for 2021

At its 9th session held on 2 November 2021, the Fiscal Policy Commission (hereinafter: Commission) discussed the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for 2021, which were submitted in the form of an act to the Speaker of the Croatian Parliament by the Croatian Government on 28 October 2021.

The proposed amendments to the 2021 State Budget foresee an increase in the general government budget deficit and public debt in 2021 as a result of countercyclical fiscal policy aimed at combating the epidemic and its economic consequences. The Commission agrees with this Draft Amendment, but, as many times before, emphasizes the need for better planning and control of expenditure, especially in the healthcare system.

For the second year in a row, the global economy, including the Croatian, is threatened by the COVID-19 pandemic, which requires strong funding for healthcare interventions and other measures to mitigate its economic and social effects, including supporting the recovery and increasing the resilience of the economy. Accordingly, the provisions of the Fiscal Responsibility Law and the Stability and Growth Pact have been applied, which allow a temporary deviation from the prescribed numerical rules, but only on the condition of protecting the medium and long-term sustainability of public finances.

With the proposed Amendments, the State Budget is amended for the second time in 2021; they include primarily already realized trends and activities on the revenue and expenditure side and can be considered a technical amending budget without major impact on further policies.

When considering the budget documents relating to the Draft Amendments to the State Budget, the Commission primarily focused on assessing the credibility and realism of macroeconomic and budgetary projections, their comparison with the latest projections of the European Commission (EC) in accordance with Art. 22 paragraph 2 of the Fiscal Responsibility

Law and the analysis of the situation in public finances and the impact of budgetary plans on the medium- and long-term sustainability of public finances from the perspective of Art. 10 paragraph 3 of the Fiscal Responsibility Law. In particular, when considering the adopted measures, the Commission observed their targeting, short duration and temporary nature, and did not consider the temporarily postponed numerical fiscal rules from the preventive part.

Macroeconomic projections

The economic policy measures taken, combined with vaccine development and greater consumer optimism, have contributed to the rapid recovery of economic activity nationally and globally. The trends realised, especially during the summer months of 2021, indicate that the Croatian economy will already reach pre-pandemic levels in 2021.

In the Draft Amendments to the State Budget for 2021, the Government of the Republic of Croatia has increased expectations about economic growth, and predicts that in 2021 the growth of real gross domestic product will amount to 9% (compared to 5% from the initial Draft Budget for 2021 and 5,2% from the Convergence Programme, whose macroeconomic projections are incorporated in the first Amendments to the 2021 State Budget from June 2021). This is mainly due to the growth in private and government spending and the recovery of exports of services (tourism).

The Commission assesses macroeconomic and budgetary projections based on their realism, and by comparison with EC forecasts. However, the latest available EC forecasts were published in July and do not include the recovery in the second and third quarters of 2021, and predict GDP growth in 2021 of only 5.4%. However, the EC should increase its expectations in the upcoming Autumn Forecast, so that the deviation of these two projections is expected to decrease by as much as 3.6 percentage points. However, the Commission emphasizes the fact that the Government's projections are higher than the projections of other relevant institutions and points to the need for a more conservative approach when making projections for the next period, especially since part of the growth previously projected for 2022 has been achieved in 2021, whereas growth in the next medium-term period is generally limited by a low potential growth rate.

Assessment of the Draft Amendments to the State Budget for 2021

The proposed Amendments to the State Budget for 2021 involve an additional increase in the revenue and expenditure of the State Budget. Given the specific circumstances, during the assessment it needs to be identified to what extent these amendments are targeted, temporary and transient. It should also be emphasized that the proposed amendments are of a technical nature as they largely reflect the activities already carried out. On the revenue side, the amendments relate primarily to better-than-expected performance. On the expenditure side, the amendments relate to measures taken to combat the effects of the pandemic, but also to some items that do not meet the target and temporality requirements. The Commission continuously emphasizes the need to better anticipate certain items such as staff and pension expenditure, and in particular health expenditures, which are often initially planned at unrealistically low levels, in order to be increase with subsequent amendments.

Total budget revenues should amount to HRK 153.6 billion (of which operating revenues amounting to HRK 152.9 billion, and revenues from the sale of non-financial assets HRK 769 million) and are increase by HRK 3.3 billion, which primarily results from generating better tax revenue stream, which increased by HRK 2.4 billion compared to the amendments from June. Higher budget revenues are primarily the result of a better tourist season and stronger economic activity.

Total state budget expenditures shall increase by HRK 6 billion (from HRK 167.3 to HRK 173.3 billion). Expenditures financed from general revenues and receipts, contributions and assigned receipts shall increase by HRK 7.1bn, while expenditures financed from the EU and other sources shall decrease by HRK 1.1bn. The increase refers to additional funds for debt settlement and the functioning of the healthcare system (HRK 1.5 billion) and support for preserving jobs in activities affected by the COVID-19 epidemic (HRK 608 million). However, expenditures not related to the consequences of the pandemic, such as expenditures for employees (HRK 929 million) and pensions (HRK 672 million), as well as the contribution to the EU budget (HRK 495 million), have also increased. In addition, an advance is planned for the procurement of fighter jets of HRK 2.4 billion, which will be reported in 2023 according to the ESA methodology.

In accordance with the planned revenues and expenditures, the State Budget is expected to post a deficit of HRK 19.7 billion or 4.7% of GDP, which is a significant deterioration compared to what was previously planned (e.g. 2.7% of GDP from October 2020 and 4.2% of GDP from June 2021.) The general government deficit, according to the ESA 2010 methodology, will amount to HRK 18.9 billion or 4.5% of GDP (which also provides for a significant increase compared to the original plan from October 2020, which amounted to 2.9%, and the first amendments from June 2021, which envisaged a deficit of 3.8%). Based on the development of the fiscal balance of the general government budget, the share of public debt in GDP in 2021 is expected to decrease by 4.2 percentage points compared to 2020 and will amount to 83.1% of GDP.

Although the projected deficit exceeds the reference value of 3 % of GDP, the Commission considers that increased government spending was necessary in the previous period to mitigate the negative effect of the pandemic. However, the Commission considers that part of the increased government spending did not involve expenditures directly related to combating the pandemic and addressing related economic damage, nor was it of a temporary nature, but referred to a permanent increase in general budget spending in the form of increased expenditures for employees and pensions in the amount of HRK 1.7 billion only in this Draft Amendment to the State Budget, which will spill over to the next year with likely pressures for further increases due to stronger inflation.

Therefore, in view of the achieved economic recovery, a stronger fiscal consolidation is required, which should take into account measures to ensure funds that are aimed at investments and reforms needed to increase the potential growth rate, which would be financed as much as possible under EU support programmes, and as little as possible from own sources of funding. In the conditions of accelerated population aging, the concept of intergenerational solidarity is also compromised, a concept under which the costs of current consumption are passed on to future generations, so it would be desirable to take certain reform measures without compromising the basic principles of the already implemented pension reform. Primarily, this refers to the reform of the healthcare system in such a way that it does not generate additional losses that are continuously, year after year, object of the amending budget.

6.5. 15th Position Paper of the Fiscal Policy Commission on the Draft State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024

At its 10th session held on 24 November 2021, the Fiscal Policy Commission (hereinafter: Commission) discussed the Draft State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024.

The Fiscal Policy Commission supports the Draft State Budget for 2022, the year in which fiscal rules will still not be applied. The Commission warns of the risk of exceeding expenditures in certain categories and reiterates that the period of intense growth should be used for enhanced fiscal consolidation. The key to fiscal sustainability is a strong economy which requires reforms and investments, relying on EU funding.

In its position on the draft budget, the Commission expressed its opinion on the continued temporary postponement of the application of fiscal rules in 2022, macroeconomic projections, the draft state budget and the evaluation of fiscal rules in 2023 and 2024 when it is expected that fiscal rules might be reinstated.

Continued temporary postponement of the application of fiscal rules in 2022

In accordance with its duties defined in Article 22 of the Fiscal Responsibility Act (FRA), and on account of the exceptional circumstances referred to in Article 10 of the FRA, the Commission continued with the temporary postponement of the application of fiscal rules defined in Articles 6, 7 and 8. On 2 April 2020, based on the Commission's opinion of 30 March 2020, the Government adopted the Decision on the temporary postponement of the application of fiscal rules in 2020[19], enabling measures to mitigate the effects of the epidemic on the citizens' health and the economy, which contributed to a faster recovery of economic activity.

[19] Available at: https://narodne-novine.nn.hr/clanci/sluzbeni/2020_04_41_856.html.

Additionally, in its 10th Position Paper of 2 November 2020 on the Draft State Budget for 2021,[20] the Commission supported the continued postponement of the application of fiscal rules in 2021 on account of significant macroeconomic risks and uncertainties related to the epidemic that might negatively affect the achievement of the planned income and necessitate further fiscal measures to mitigate the consequences of the epidemic. The Commission warned that, in doing so, fiscal sustainability in the mid-term must not be jeopardized, which is why the provisions related to the postponement of the fiscal rules must be consistently followed, while fiscal measures must be short-term, efficient and aimed at fighting the effects of the epidemic.

Although it is not predetermined when and how the Decision on the temporary postponement of fiscal rules will be set aside, the Commission stresses the fact that this measure is a temporary one, and that, in preparing budgetary documents for the upcoming period, it is necessary to assume that fiscal rules will be relaunched after 2022. In other words, at the request of the Government of the Republic of Croatia, the Commission should also provide its opinion on the existence of extraordinary circumstances for 2022, as defined in Article 10 of the FRA, which make it necessary to continue the temporary postponement of the application of fiscal rules in 2022.

In establishing the existence of extraordinary circumstances, the Commission also examines the very event that led to the extraordinary circumstances, the impact on public finance, economic activity and the related risks, as well as the application of economic governance at the level of the EU.

The Commission has established the following:

1. The coronavirus epidemic is still under way, and it is uncertain when it might end.
2. Therefore, medical intervention and fiscal support to vulnerable citizens and companies need to be reinforced further. However, since the expected level of fiscal support for 2022 is much lower than for 2020 and 2021, it could be treated as fiscal support related to an extraordinary event as is normally used in evaluating the fulfilment of fiscal rules.

[20] Available at: https://www.sabor.hr/sites/default/files/uploads/inline-files/10.%20stajali%C5%A1te_Povjerenstvo%20za%20fiskalnu.pdf

3. After sharply declining in 2020 (-8,1%), Croatian economy recovered completely in 2021. Macroeconomic projections foresee the accelerated growth continuing in the upcoming years, but macroeconomic risks will still be significant because the epidemic continues.
4. In its instructions for preparing the Convergence Programme, in March 2021, the European Commission announced and confirmed in its Spring Forecast issued in May 2021[21] that the general clause on the postponement of the application of fiscal rules would continue in 2022, and invited the Member States to continue with the fiscal support in order to prevent an abrupt contraction of economic activity. Furthermore, at the level of the EU, a discussion continues on the reform of the economic governance framework and amendments to fiscal rules, and it is evident that changes will be introduced both to the framework and to the manner of its application.

Accordingly, the Commission holds that the improved economic situation in Croatia in 2021 indicates that the extraordinary circumstances referred to in Article 10 are less prominent and that the fiscal effects of the epidemic could be addressed through existing exemptions within the set fiscal rules. However, considering the continuation of the epidemic and the fact that fiscal rules are still suspended at the level of the EU under the general escape clause, the Commission holds that the existing circumstances allow for the temporary postponement of the application of fiscal rules to continue in 2022.

In that respect, the Commission underscores the need to pay special attention to mid-term sustainability of public finances, while additional fiscal spending measures must be targeted, temporary and short-term. In 2021, certain deviations occurred to these guidelines and, in addition to those related to the epidemic, measures were also introduced on the income and expenditure sides with a permanent negative effect on public finances. Furthermore, it is necessary to continuously and carefully analyse the sustainability of public finances, first and foremost through the Report on the application of fiscal rules which is an integral part of all the Government's budgetary documents, regardless of whether the Decision on the temporary postponement of the application of fiscal rules enables temporary deviation from quantitative fiscal criteria or not.

[21] Available at: https://ec.europa.eu/economy_finance/forecasts/2021/spring/ecfin_forecast_spring_2021_hr_en.pdf

The Commission also stresses that the period of accelerated growth, expected in 2022, must be used as a transitional period toward the consolidation of public finances and reinforcing economic resilience and potential, whereas the plans for 2023 and 2024 must be compliant with the existing fiscal rules.[22]

Macroeconomic projections

Pursuant to the FRA, the Commission considers the macroeconomic and budgetary projections from mid-term budgetary documents and compares them with the most recent available ones, EC's Autumn Forecast in this case.[23]

Macroeconomic projections incorporated in the Draft State Budget for 2022-2024 include results in terms of growth of personal and national spending, as well as tourist activity throughout the summer months of 2021 which are better than expected in the previous forecast from the Convergence Programme[24] and Economic and Fiscal Policy Guidelines[25]. In 2021, the Government expects economic growth of 9 % which would result in a complete recovery of economic activity, after it decreased by 8.1 % in 2020, and its return to pre-pandemic levels. It also expects economy to continue growing faster than the potential growth in the upcoming years, i.e. by 4.4 % in 2022, 3.7 % in 2023 and 3.1 % in 2024. These high growth expectations include significant positive effects of the National Recovery and Resilience Plan (NRRP)[26]. GDP growth will be based on increased domestic demand, while net foreign demand is expected to have a slightly negative contribution. With the expected increase of deflators, in 2021, GDP expressed in the current prices will exceed the level from 2019, and nominal GDP will also continue its strong growth in the upcoming years.

[22] This includes following the EC's instructions on the application of fiscal rules for 2023 expected early next year.

[23] Unlike the Euro area member states where independent fiscal bodies prepare or endorse macroeconomic projections, the FRA does not include such a provision.

[24] Available at https://vlada.gov.hr/UserDocsImages//2016/Sjednice/2021/Travanj/55%20sjednica%20VRH/Dokumenti%20NOVO//55%20-%202%20Program%20konvergencije.pdf

[25] Available at https://vlada.gov.hr/UserDocsImages//2016/Sjednice/2021/srpanj/71%20sjednica%20VRH//71%20-%207%20Prijedlog%20smjernica.docx

[26] Available at: https://planoporavka.gov.hr/UserDocsImages/dokumenti/Plan%20oporavka%20i%20otpornosti%2C%20srpanj%202021..pdf?vel=13435491

Based on its latest available Autumn Economic Forecast[27] published on 11 November 2021, the EC expects similar trends and dynamics as the Government of the Republic of Croatia. However, the EC expects that GDP will increase by 8.1 % in 2020, and that recovery back to pre-pandemic levels will be achieved in early 2022 when GDP will grow by as much as 5.6 %, and that strong growth will continue in 2023 (3.4 %). In that respect, the EC expects a slightly slower growth of the deflators in the upcoming years, including a lower nominal growth rate.

The macroeconomic projections of the Government of the Republic of Croatia and the European Commission presented in Table 1 indicate that the Croatian Government and the EC both predict a very fast economic recovery after the slump in 2020. In that regard, the Croatian Government predicts that such recovery will already be achieved in 2021, while the EC projects it for 2022. In other words, their projections for 2021 and 2022 differ only in terms of the speed of recovery in 2021and 2022, as evident from the aggregate of real growth by 2023, which makes them almost identical.

Table 1 Comparison of macroeconomic projections of the Croatian Government and the European Commission

	Government				*EK*			*Difference*		
	2021	2022	2023	2024	2021	2022	2023	2021	2022	2023
GDP	9.0	4.4	3.7	3.1	8.1	5.6	3.4	0.9	-1.2	0.3
Aggregate	9.0	13.8	18.0	21.7	8.1	14.2	18.0	0.9	-0.4	0.0
Deflator	2.4	2.6	2.3	2.2	2.4	2.1	1.9	0	0.5	0.4
Nominal	11.6	7.1	6.1	5.4	10.7	7.8	5.4	0.9	-0.7	0.7
Aggregate	11.6	19.6	26.8	33.6	10.7	19.3	25.8	0.9	0.2	1.1

The Commission concluded that macroeconomic projections of the Croatian Government do not significantly deviate from EC's projections for the next two years, and holds that the proposed projections of the Croatian Government are appropriate. The Commission also underlines the need for the Government to carefully monitor the achievements of macroeconomic fluctuations and utilization of EU funds to be able to adjust them in a timely manner in case of any deviations.

[27] Available at https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/autumn-2021-economic-forecast_en

Evaluation of the Draft State Budget for 2022 and the Projections for 2023 and 2024

Total state budget income is planned in the amount of HRK 164.5 billion in 2022 and HRK 167.7 billion in 2023 and 2024. Total income in 2022 includes a planned increase of surtax from value added tax and contributions, and especially aid (which is expected to increase by as much as HRK 8.3 billion). Income trends are adjusted to macroeconomic projections, and the Commission holds that the projection of income is realistic.

Total planned expenditure in 2022 financed from all the sources amounts to HRK 173.8 billion and exceeds the total expenditure planned by the last amending budget from October 2021 by HRK 0.5 billion, whereas the total expenditure planned is HRK 169.8 billion for 2023 and HRK 166.5 billion for 2024. Expenditures financed from sources that affect the result of the general government budget in 2022 are planned in the amount of HRK 127 billion, which is a decrease compared to the last amending budget from October 2021 in the amount of HRK 5.6 billion. These fluctuations are primarily conditioned upon the significant decrease of the transfer of budget funds to the Croatian Health Insurance Fund, subsidies paid out to businesses for retaining employees, funds for remediation of hospitals' debts and one-off payments to pension beneficiaries.

On the other side, a significant increase can primarily be seen in the expenditure related to the consequences of the earthquake, the social welfare system, pensions and the pension system as well as interest on bonds and loans. This kind of planning foresees that the overall result will lead to a significant decrease of the state budget deficit which is estimated, in 2022, at HRK 9.3 billion (2.1 % of GDP, with a tendency to further decrease in the upcoming years: to HRK 2.1 billion or 0.4 % in 2023 and HRK 1.2 billion or 0.2 % in 2024).

Despite the planned decrease of expenditure affecting the deficit due to the abolishing of a number of epidemic-related expenditure categories, the Commission is of the opinion that significant risks are present that might lead to exceeding the planned amounts, exactly in those categories where the plan often goes through the roof. For this reason, savings are planned for next year because of the exclusion of funds for the recovery of the healthcare sector (HRK 4 billion), and the discontinuance of the support for the economy (app. HRK 4.2 billion) which might be necessary again if an urgent reform is not implemented and the epidemic continues.

In addition, certain expenditure categories, especially the expenditure for employees and pensions, are again planned in the amount which will probably be insufficient because it depends on the outcome of collective negotiations.

Defined as above, the Draft State Budget for 2022 and the projections for 2023 and 2024 indicate an intention to quickly consolidate public finances and respect the reference level of 3 % of deficit which, however, might be exceeded. According to the ESA methodology, a general government deficit is projected in the amount of 2.6 % of GDP for 2022, decreased to 2.4 % in 2023, and to 1.6 % in 2024. These fluctuations of the general government budget in 2022 are mostly affected by the planned deficit within the framework of the state budget and the budget for local and regional self-government units. However, in case of achievement of the risks indicated on the expenditure side, the planned deficit might be exceeded. In addition, after public debt reached a new high, as measured by the share in GDP, in the amount of 87.3 % in 2020, its decrease to 83.1 % is planned in 2021 and its further decrease to 80.7 % in 2022, 78 % in 2023 and 75.3 % in 2024.[28]

Evaluation of the fiscal situation

Fiscal rules are a facility for the achievement of the objective of the Fiscal Responsibility Act, which is to ensure long-term fiscal sustainability. In the circumstances of a great economic shock caused by the coronavirus epidemic, strong fiscal support was necessary to mitigate the negative consequences for the people and the economy. The price of the implemented successful intervention, which resulted in a very quick economic recovery and a resumption of the growth trend, is an increased public debt and state budget deficit. Since accelerated economic growth is expected in the upcoming years, when additional and significant fiscal support will no longer be necessary, the Commission highlights that fiscal consolidation must be launched as soon as possible, under the condition that it does not jeopardize structural reforms and investments necessary to ensure intensified economic activity.

The existing fiscal rules, as well as the expected amendments, represent an important instrument for ensuring such consolidation; therefore, the Commission reiterates that the

[28] These public debt projections also slightly differ from EC's 2021 Autumn Forecast which foresees a share of public debt in GDP of 82.3 % in 2021, 79.2 % in 2022 and 77.9 % in 2023.

existing Decision on the temporary postponement of the application of fiscal rules relates only to 2022 and that, pursuant to the expected high economic growth rates, following of the existing fiscal rules in 2023 and 2024 must be ensured in the upcoming period.

Since the Croatian Government did not depict the *structural balance* analyses in its budgetary documents, the Commission is basing its evaluation on the estimates from EC's Autumn Forecast. According to EC's forecast, after years of intense growth before the pandemic when the production gap was positive and very high, the big decline caused by the pandemic caused a production gap to drop in 2020 to -6.0 % of GDP, while economic activity below the potential level continued in 2021 amounting to -1.3 % of GDP. However, quick economic recovery and growth will result in a positive production gap amounting to 1.1 % in 2022 and 1.4 % in 2023. If the production gap calculated in this manner is applied to Government's projections, structural deficit will remain at the level of about 3 % of GDP until 2024 – as projected for 2021. Besides the indicated risks related to exceeding certain expenditure categories, these plans show that the projections for 2023 and 2024 do not foresee sufficient fiscal consolidation.

The purpose of the *expenditure rule* is to prevent the state spending (expenditure growth plus one-off measures on the income side), measured as the share in GDP, from increasing in the mid-term. According to the Commission's assessment, the growth in expenditure should not exceed the reference level.

The *debt rule* is crucial for long-term sustainability of public finances because it restricts the growth of current spending at the expense of future generations. According to the debt rule, public debt may not exceed 60 % of GDP, that is, debt must decrease on average by 1/20 of the amount above the reference level. Before the pandemic, Croatia fulfilled this rule, but, in 2020, public debt increased abruptly and reached a share of 87.3 % in GDP. According to budgetary projections, in the upcoming period, the Croatian Government is planning a decrease of the share of public debt in GDP at an average rate of 2.5 percentage points per year, which is much more than the minimum debt reduction requirement, meaning the public debt rule would be fulfilled.

Since this Position Paper focuses on 2022, the Commission supports the draft State Budget for 2022, but also calls on the Government to use the accelerated growth period for stronger fiscal consolidation by limiting to the greatest possible extent the adoption of fiscal measures with a permanent effect on expenditure. In doing so, it is important to secure resources targeted at investments and reforms necessary for increasing the potential growth rate, while maximizing the use of EU funds and minimizing the use of own funding, While preparing the Convergence Programme and budgetary documents for 2023, the Croatian Government is called on by the Commission to examine in more detail the structure of public spending and adopt such measures that ensure public finances are adjusted to the current and future fiscal rules.

Again, as many times before, the Commission underlines the need for improved planning and control of the expenditure and warns of the risks on the expenditure side (healthcare, employees, pensions, support for the economy). In a situation of accelerated population ageing, the concept of intergenerational solidarity is also jeopardized because, according to this concept, the costs of current spending are transferred onto future generations. It would therefore be beneficial to undertake key reform interventions, without endangering the basic settings of the pension reform that has already been implemented. The strongest emphasis is placed on the reform of the healthcare system so that it does not generate additional losses which have been the subject of the amending State Budget year after year.

The key instrument of a stronger fiscal expansion are EU funds. High-quality, economically sustainable, strategic, and development- and reform-oriented projects based on EU funds as well as the EU Solidarity Fund must be used in the next seven-year budget period to impact economic growth and development of the Republic of Croatia. In other words, projects with the greatest potential for reforms and contribution for growth of potential GDP as well as an increase in fiscal sustainability are instrumental for the attainment of these plans. What remains the greatest threat to this plan is the low efficiency in contracting and withdrawing the funds. In conclusion, we can state that, considering the fact that fiscal sustainability was primarily related to economic growth, the lack of certain crucial reform interventions at the level of the Republic of Croatia will prevent stronger economic growth; therefore, the use of funding from the Recovery and Resilience Facility must be increased and, accordingly, as many high-quality projects as possible should be prepared.

The Commission session was headed for the first time by the newly elected Chairwoman, prof. Sandra Krtalić, PhD.